

## **Sources of variation in hospital financial performance under prospective payment**

**ISSUE:** What factors account for the wide variation in hospital inpatient PPS margins that we observe annually? Can we develop a broadly applicable approach that could be used to evaluate variation in providers' Medicare PPS margins for services furnished to beneficiaries in many care settings?

**KEY POINTS:** The methods, data, and preliminary findings described in the attached paper represent the first installment on our multivariate analysis of variation in hospital inpatient PPS margins. The design and implementation of this analysis has been carried out for MedPAC by Kathleen Dalton, Ph.D. at the Cecil G. Sheps Center for Health Services Research in the University of North Carolina. Based on the analysis to date, we are able to account for less than one half of the variation in hospitals' inpatient PPS margins:

- Payment variables included in the hospital inpatient PPS play an important role, accounting for somewhat more than one quarter of the PPS margin variation.
  - Most of this variation reflects the role of policy adjustments—as opposed to cost-related factors—such as payments above the estimated cost relationship for the indirect costs medical education, additional payments for hospitals serving a disproportionate share of low-income patients, and special payment provisions for certain rural hospitals.
  - A small portion appears to be attributable to measurement problems affecting certain cost-related payment variables, including the relative weights for the diagnosis related groups, the wage index, and the large urban payment differential.
- An additional 15 percent of margin variation is explained when provider characteristics are added to the model. Some of these (occupancy, length of stay patterns) are subject to management control. Others may reflect market conditions that are not adequately addressed in the PPS and may represent opportunities for PPS refinements.
- The remaining one half of the variation is currently unexplained. We are continuing our analyses to explore systematic margin differences by region and ownership and to test the effects of additional variables that describe local market conditions.

**ACTION:** We would appreciate feedback from the Commission on our methods, findings, and issues for further work.

**STAFF CONTACT:** Julian Pettengill (202 220-3725).